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Financial Markets

Irving Trust

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Lack of clarity about the direction of Fed policy frequently is accompanied by unsettled conditions in the financial markets. Yet this lack of clarity is not uncommon. The Fed--necessarily--moves from tightening to easing, and easing to tightening, in gradual steps. These steps are not particularly definable, although certain characteristics of the process can be identified. Moreover, market participants undoubtedly detect far more Fed tightenings and easings than the Fed itself intends. These participants might ask why Fed policy isn't more clearly articulated. Why indeed?

The answer really is not so difficult to divine. Because the Fed is so powerful--because monetary policy is so important--the Fed is a careful custodian. But this statement has no clear implication: A plodding and reactive monetary policy can be just as damaging as an overly aggressive one. Thus the Fed generally tries to err on the side of ease or tightness that will least damage the economy if the policy turns out to have been wrong in light of subsequent events. Earlier this year, the Fed erred on the side of tightness. While rates did not soar, they did begin to firm up in May, before even the Fed could be sure of the strength of recovery. The Fed's actions were based on fear of inflation (fast M1 growth) and the hope that the recovery would not be aborted. Subsequently the Fed eased, out of concern about the sustainability of economic recovery. The question now is: What does the Fed fear the most?

Right now, the Fed has no "greatest fear," so its policy is balanced and directionless. Some FOMC members clearly fear inflation and are talking publicly about the dangers. Others, while not as vocal, fear for the continuation of recovery. Therefore the FOMC has no consensus, and it acts more cautiously. Earlier this year, we saw the FOMC act in the absence of a consensus. In a split vote, it moved to tighten in mid-May, and rates rose 40 basis points amid erratic net free to net borrowed reserve figures. But once the FOMC obtained a consensus (on June 23 in a telephone conference), the reserve figures clarified and joined the pattern previously established by the Fed funds rate. Operationally, the Fed engineered the tightening (after May 18) by moving from a policy of leaving Wednesday in a position of net borrowed reserves to making it net free and putting the earlier part of the statement week in a net borrowed position. This procedure makes the market less liquid Thursday-Tuesday than the weekly reserve figures indicate. Yet, it does not necessarily change the pattern of average weekly reserves, even though it results in more pressure on the Fed funds rate.

For now, the Committee appears to have reversed this procedure. The highly publicized net free-net borrowed statistics indicate more tightness than the Fed actually is putting on the day-in and day-out market because much of the pressure comes on Wednesday. <u>There seems to be no consensus within the FOMC to tighten, but there is a willingness to send a signal of caution</u>. Remembering that the FOMC <u>is</u> a committee, we must come to understand its policy as the result of collective action. Having tightened in mid-May and eased three to four months later, it's not impossible that the Fed would tighten again now (two to three months after the easing). Yet this seems unlikely because monetary growth has been within bounds, and the pace of recovery is slowing. In this cycle, the second consensus to tighten may be harder to get.

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Market Yields

	12/9/83 (Noon)	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company	11.00%	11.00%	11.50%
Effective since	8/8/83		
Discount Rate at Federal Reserve Bank	8.50	8.50	9.00
Federal Funds	9.44	9.50	8.88
Repurchase Agreements	9.40	9.40	8.75
U.S. Treasury Issues			
Bills			
3 months	9.33	9.22	8.23
6 months	9.74	9.64	8.76
1 year	10.08	9.99	9.02
Coupons			
2 years	10.82	10.73	9.78
4 years	11.38	11.26	10.47
7 years	11.79	11.64	10.78
10 years	11.86	11.70	10.59
Long Bond	11.93	11.75	10.54
Negotiable Certificates of Deposit-Secondary Market			
1 month	9.55	9.30	8.60
3 months	9.65	9.40	8.80
6 months	9.95	9.60	9.00
1 year	10.45	10.15	9.40
Banker's Acceptances			
1 month	9.52	9.33	8.60
3 months	9.75	9.47	8.80
6 months	9.94	9.69	9.10
Eurodollar Deposits			
1 month	10.19	9.75	9.56
2 months	10.19	9.81	9.63
3 months	10.25	9.88	9.75
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	9.53	9.29	8.76
1 month	9.66	9.33	8.81
3 months	9.60	9.49	8.68
Bank Holding Companies			
1 month	9.19	8.94	7.65
Dealer Placed:			
3 months	9.73	9.44	8.81
New AA Corporate Utility Bond	13.20	13.00	12.00
Tax Exempt			
6 month Project Notes	5.55	5.50	4.90
1 year AAA Bond	6.00	5.50	5.25
5 year AAA Bond	7.25	7.45	7.00
20 year AAA Bond	9.25	9.40	9.50

This information represents prevailing market yields.
It should not be construed as an offering.
All yields are on the offered side of the market.

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